Examiner's report

F7 Financial Reporting
December 2010

General Comments

I am delighted to say that the overall performance of candidates on this diet was much improved from the disappointing results of recent diets.

Most commentators believed this to be a fair paper for which a well-prepared candidate could readily attain a pass mark within the time constraints of the examination.
As with past papers, the best answered questions were the consolidation in question 1 and financial statements preparation in question 2. An important difference in this diet was that there were many good answers to the performance appraisal in question 3. Even the normally low-scoring questions 4 and 5 that related to the wider syllabus areas provided many reasonable attempts.

Despite the above, there a still a significant number of candidates that did not answer question 4 or 5 and sometimes both, but not on as large a scale as previously reported.

I am pleased to report that as a reflection of the above, there were many strong marks in the 70s and even higher from some truly impressive candidates.

There were some examination technique issues that caused problems for some candidates. Answers with no or unreferenced workings to support them were common. Markers cannot allocate any marks to an incorrect figure unless they can see how the figure has been arrived at.

Poor handwriting was a particular problem on the interpretation section of question 3 with markers reporting difficulty reading (and therefore awarding marks to) several scripts. There was also evidence of candidates not answering the question that was asked, which I refer to in the individual question commentary below.

The composition and topics of the questions was such that on this diet there was very little difference between the International Paper (the primary paper) and all other variant papers, thus these comments generally apply to all streams.

Specific Comments

Question One
This required the preparation of consolidated statements of comprehensive income and financial position. It included a fair value adjustment for a downward valuation of the subsidiary's property and the related reduction in the post-acquisition depreciation. Further adjustments required the elimination of current account balances and intra-group trading, including unrealised profit (URP), and an increase in the value of available-for-sale investments.

The majority of candidates clearly have a good working knowledge of consolidation techniques which showed through in good marks for this question. As usual it was the more complex aspects where errors occurred:
Consolidated statement of comprehensive income

Intra-group sales should only be eliminated for the post-acquisition period (4 months), many deducted $12 million (being for 12 months) or $2 million (being the amount remaining in closing inventory).
Several candidates calculated the URP as $500,000 ($2 million x 25%), but the 25% was a stated as a mark-up on cost which gave $400,000 ($2 million x 25/125).

The fair value reduction in the depreciation charge was often added rather than deducted from cost of sales.

One or both other comprehensive income gains were often shown in the income statement rather than under other comprehensive income

Most candidates understood the principle of calculating the non-controlling interest (NCI); however, the adjustments to the subsidiary's post-acquisition profit for the URP and/or reduced depreciation were frequently omitted from the calculation.

Consolidated statement of financial position
As with the income statement most candidates scored well, however the problem areas were:

Treating the fair value reduction of the property as an increase.
Some candidates used the subsidiary's share value (of $3.50) to value the consideration paid by the parent (Premier) ($5 should have been used) and several did not include the consideration (fair value) of the NCI, effectively only calculating the parent's share of the goodwill (note this does not apply to UK based answers).

A surprising number did not correctly calculate the subsidiary's net assets at the date of acquisition due to either an incorrect pre- and post-acquisition apportionment of the profit for the year and/or including the post-acquisition depreciation adjustment (and sometimes the URP in inventory) as pre-acquisition.
The majority of candidates did not eliminate the loan notes given as part of the purchase consideration from the carrying amount of the available-for-sale investments.
Many did not attempt to record the increase in the parent's share capital and premium as a result of the share exchange.

A considerable number of candidates added the increase in the value of the parent's property to the land revaluation reserve, not realising it had already been included (note this does not apply to UK based answers).

As already stated, despite these errors, there were many good scores on this question. However, it should be said that there were a small minority of candidates that appeared to have done very little study or preparation and made fundamental errors. These included using proportional consolidation and/or not time apportioning the relevant income statement items, whilst some candidates even time apportioned the statement of financial position balances, revealing a complete misunderstanding of the subject.

Question Two
This question was a traditional preparation of financial statements from a trial balance combined with several adjustments including: a rights issue of shares and the accompanying dividend calculation, the issue of loan note in a prior year, revaluation of land and buildings, accounting for an environmental provision as part of the cost of a non-current asset and accounting for taxation.

As with question 1, this was attempted by nearly all candidates and was well answered by most with many high scores. Most of the problems were with the adjustments and even where candidates did not get them fully correct, they often picked up some of the marks. The frequent problems areas were:
Statement of comprehensive income.

Many candidates got the dividend calculations wrong mainly because the first dividend was paid before the rights issue and therefore based on a different number of shares to those in issue at the year end. Weaker candidates added the dividends to the administrative expenses which shows a serious lack of understanding and some candidates deducted the dividends in the income statement rather than in their answer to part (b).
A high number of candidates did not capitalise the future decontamination (environmental) costs related to the acquisition of some new plant, this had a knock on effect with depreciation, the creation of the related provision and the unwinding of the first year's discount (see below).

Some candidates treated the revaluation of the land and building as being at the beginning of the year rather than at the end of the year and some did not account for depreciation before calculating the revaluation gain (effectively combining the two). This is an issue I have reported on repeatedly.

Very few candidates got the finance costs totally correct, many did not use the effective interest rate (they instead used the nominal rate) on the loan note, and even fewer included the unwinding of the environmental provision as a finance cost and some even omitted the bank interest.

Most scored well on the tax, but there was the usual error with deferred tax of charging the closing provision to the income statement rather than the movement in the provision, a number also got the sign of the various components wrong (i.e. adding rather than deducting or vice versa).

Many candidates misclassified one or both items of other comprehensive income by including them in the income statement.

Statement of changes in equity
This was generally very well done. I should mention that although many of the figures (profit for year dividends paid, share issue, etc) were incorrect as a result of earlier errors they were not penalised in this statement and marked as correct under the principles of method marking. The most common problem was treating the share issue as being in addition to the $50 million shown in the trial balance, in fact this figure already included the new issue and candidates should have worked back to calculate the opening share capital. There were also a many errors in the actual calculation of the share capital and share premium.

Statement of financial position
This was again generally well done with most errors being due to the knock on effect of errors made in the statement of comprehensive income which, as noted above, were not generally penalised. The omission of the environmental provision (and its accumulated finance cost) was the most common error and many candidates still have difficulty with calculating and correctly classifying taxation (current and deferred) balances in this statement. Weaker candidates showed the bank overdraft as a current asset and/or the available-for-sale investments at their trial balance (rather than their fair)value.

Question Three
This question was a full 25 mark performance appraisal question. The question required candidates to calculate ratios (of their choice) for up to 10 marks in order to assess the performance of a company against the background of a global recession. Important information in the scenario, in addition to the challenging market conditions, included mention of losses sustained by the company due to falls in property prices, the reduced carrying amounts of investments, redundancy costs and some cost savings in advertising and administrative costs.

A good answer should have considered the effects of this information and look to see beyond the reported figures at what the underlying performance would have been but for the economic problems. A number of candidates did try to calculate some underlying ratios (i.e. assuming the ‘one-off’ costs had not occurred) and comment on these comparing performance with 2009, but most did not attempt this analysis.

I am pleased to report that the average mark on this question was much higher than the equivalent in many recent diets; this is especially so as normally I expect weaker marks on interpretation when compared to the alternative equivalent cash flow question. Most candidates scored well on the calculation of ratios, although unpractised candidates showed a distinct lack of understanding of the definitions and meaning of some ratios, particularly return on capital employed and gearing (for example, using just the share capital as equity is not acceptable). Markers did allow some flexibility within the definitions of some ratios.

Overall many candidates did make intelligent comments about the change in the ratios and what might have caused them, however there were too many candidates who that thought that saying a ratio had gone up or down amounted to interpretation – it does not. There were also answers that did not refer the events in scenario at all. A small, but significant number of candidates produced a statement of cash flows as their answer to this question. This was a pointless exercise; it is not what was asked and gained no marks (even if it was correct). Clearly these candidates had gambled on statements of cash flows coming up - question spotting is often a fatal error.

Question Four

The introductory section (part (a)) of this question required candidates to explain the basis on which accounting policies must be selected and to distinguish between (with an example) changes in accounting policies and changes in accounting estimates. Those candidates that had studied this area did well, with the opposite being true for those that had not; thus answers where rather polarised into good and weak. A common area where many candidates 'went off topic' was that they spent considerable time explaining the circumstances where an entity should change its accounting policy and the procedures to be followed if it did. A question like this had been asked in a previous diet, but it was not what this question asked. I believe this illustrates well the point that while it is important to study and practice past questions, do not to expect them to be repeated in exactly the format.

Although there were many good scores on this section, a very common point of misunderstanding is that many candidates thought that changing from straight-line to reducing balance depreciation was a change of policy; this would be an example of a change of an accounting estimate.

A few candidates chose to discuss the correction of errors aspects which was not relevant to the question asked.

Part (b) contained two examples related to part (a), the first was a proposal to increase the life over which an asset should be depreciated (from an original five years to eight years in total) and the second was a change in the basis for valuing inventory (from FIFO to average cost).

Answers to both were very mixed. In part (i) some candidates stated that companies could not change the depreciation life of their assets (and left the answer at that) – this is clearly wrong. There is an annual requirement for companies to review the remaining lives of their assets and if they are believed to be incorrect, they **must** be changed and depreciation charged accordingly. The accounting for the change suggested by the assistant accountant resulting in a credit for depreciation in the income statement for the current period was incorrect, but many thought it was acceptable. Another common error was for candidates to recalculate the depreciation over the total new life of eight years, whereas the correct calculation was to depreciate the carrying amount at the beginning of the period over the remaining new life (which was six years). Many candidates incorrectly treated the example given as an asset revaluation and hence discussed the need for all plant to be subject to a revaluation exercise – again this was not what the question was about.
Answers to part (ii) (the inventory change) were weaker than to part (i). Often the only mark some candidates got was for realising that it was a change of accounting policy. Weaker candidates thought this was a question about inventory being valued at the lower of cost or net realisable value - it wasn't. Many did not attempt to quantify the effect of the change in policy (despite the question specifically asking for it and giving all the relevant information) and some of those that did again agreed with the assistant accountant that the change would improve profit by $2 million (the difference in value between FIFO and average cost of the closing inventory). In fact, the change in profit would be the movement in the difference between the opening and closing inventory values ($400,000) and this would **reduce** rather than increase the profit for 2010.

Question Five

This question examined the area of provisions, in particular a provision for closure costs and the related area of discontinued operations. This was not a well-answered question, but many candidates did pick up some marks

on it. The question contained information on the redundancy and retraining costs, future trading losses and the expected sale price of the assets of a furniture making operation that was to be closed down four months after the current year end.

The information in the question pointed to the closure being irrevocable and from this most candidates correctly concluded that a provision was required. What caused most problems was which losses should be provided for and, more importantly, in which period the provisions should be made.

The closure would create an expected profit on the disposal of a factory and a loss on the sale of the plant. Many candidates offset these providing for a net amount in the year to 30 September 2010, however only the loss (an impairment) should have been provided for (the profit should be reported only when it arose: in the year ended 30 September 2011).The related costs were for redundancy and retraining, again often both were provided for together, but only the redundancy should have been provided for in the year to 30 September 2010 with the retraining costs charged as they were incurred (the following year). The final item was trading losses: $600,000 up to the year ending 30 September 2010 and a further $1million in the following period. Again many of candidates wanted to provide for all the losses in the year to 30 September 2010. IFRS rules say entities cannot provide for future trading losses (unless as a result of an onerous contract).

The most disappointing aspect of this question was that most candidates did not attempt to allocate the reporting of the losses between the two accounting periods, despite the question specifically asking for this. Indeed most of the marks were for knowing the period in which the items should be reported, whereas most candidates seemed to think that listing and quantifying the losses/expenses was all that was required.

The last aspect of the question was to consider whether the closure qualified as (and if so when) a discontinued operation. Most candidates wanted to treat it as discontinued in the year to 30 September 2010, whereas it would (probably) be treated as such in the following year.

Conclusion

Overall this was a much improved performance. Candidates scored better on the wider topic areas of questions of 4 and 5 than in recent diets. Hopefully this means more effort is being made to cover the full range of syllabus topics.

Many of the above comments on the individual questions focus on where candidates made errors. This is intended to guide candidates' future studies and to highlight poor techniques with a view to improving future performance. This may appear to give an overly pessimistic view of candidates' performance. This is not the intention, nor is it the case. There were many excellent papers where it was apparent that candidates had done a great deal of studying and were rewarded appropriately.